
Mortgage Banking — Accounting Program

Examination Objectives

To determine if the thrift is in compliance with GAAP and OTS accounting requirements.

To determine if the thrift's accounting practices are safe and sound.

To determine if corrective action is needed to correct deficiencies.

Examination Procedures

Perform the following examination steps to ensure that the accounting related to mortgage banking activities complies with GAAP and regulatory requirements. Those steps that do not apply may be omitted; however, a notation should be made as to why they do not apply.

Level I

Wkp. Ref.

1. Review the thrift's mortgage portfolio to determine if mortgages are properly classified in accordance with management's stated intent:
 - Review OTS TB 52 for factors to be considered when evaluating whether the classification of mortgages is consistent with management's intent; and
 - For mortgages transferred in from the held-for-sale portfolio, determine that the mortgages were recorded at LOCOM as of the date of transfer to establish their new cost basis. Recompute accretion to date of the difference between the new cost basis and the mortgages' face amount as of the date of transfer.

2. Review the previous report of examination and all mortgage banking accounting-related exceptions noted and determine if management has taken appropriate corrective action.

3. Review the thrift's held-for-sale portfolio to:
 - Determine that the held-for-sale portfolio is reasonably segregated by type of mortgage;
 - Determine that the portfolio is properly carried at LOCOM. Verify that net

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unrealized gains in one type of mortgage are not used to offset unrealized losses on other types of mortgages; and

- If commitments for sale are in place, verify sales prices against transaction documents.

4. Review a representative sample of mortgage sales to:

- Determine that the transactions qualify as sales rather than financings in accordance with SFAS No. 77;
- Ascertain the existence and extent of potential recourse against the thrift. (Mortgage sale and servicing agreements generally address these recourse provisions);
- Evaluate the adequacy of the liability due to recourse provisions in accordance with EITF No. 92-2; and
- If the mortgages were previously purchased by the thrift and PMSR was recorded at the time, ensure that any gain on the sale is offset against PMSR before any gain is recognized.

5. For mortgage sales on which servicing rights have been retained and ESFRs recorded, review the thrift's method of calculating ESFR:

- Determine if the normal servicing fee rates comply with GAAP and if they agree with the minimums established by the government-sponsored enterprises;
- Verify that the thrift deducts the normal servicing fee and any guarantee fee in computing the ESFR;
- Verify that no estimated float earnings or any ancillary income items are included in the computation of the ESFR;
- Determine the method for establishing prepayment speed estimates and confirm that those estimates are reasonable and conform to Section 576, Servicing; and

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- Review the assumptions employed to derive the discount rate and ascertain if they were realistic and conformed to GAAP and industry practice at the time the mortgages were sold by the thrift and ESFR was recorded:
 - Is the discount rate less than the pass-through rate on the security before the June 1989 issue of EITF 88-11?
 - Is the discount rate below market rates after June 1989?
 - Are PMSR and ESFR recorded on the same mortgages? Does the accounting for this conform to GAAP? Is this practice unsafe and unsound in this situation?

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6. Review the thrift's method of amortizing ESFR to verify that amortization is recorded using the level-yield (interest) method. (Use of a straight-line or balloon method is generally not appropriate.)
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7. Determine whether the thrift reviews the ESFR book value at least quarterly in accordance with EITF No. 86-38 to test for impairment:
- Verify that the same discount rate used to initially value the ESFR is utilized in discounting the estimated remaining cash flow;
 - Determine if actual prepayment speed experience on the underlying mortgages has exceeded the rate originally projected by the thrift when the ESFR asset was recorded. If so, verify that write-downs have been recorded and the rate of projected amortization has been accelerated;
 - Determine that prepayment speed projections have been adjusted to reflect current expectations. Ascertain that the speeds currently employed are reasonable in light of historical experience and current market projections; and
 - Verify that the book value of ESFR has not been written up in instances where actual prepayments have been slower than anticipated, but that the rate of amortization has been adjusted prospectively.
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8. Review the book value of PMSR to:

- Verify that PMSR acquired via table funding arrangements meets the guidelines set forth in EITF No. 92-10;
- Determine that amortization is recorded using one of the proportional methods as specified in SFAS No. 65. If the thrift uses another similar method, such as sum-of-the-years digits, verify that the result is not materially different;
- Verify that amortization rates are adjusted prospectively to reflect differences between anticipated and actual prepayment speeds;
- Verify that impairment tests are performed on at least a quarterly basis and that they utilize the original discount factors implicit in the price paid to acquire the rights;
- Determine that the original discount factors implicit in the price paid to acquire the rights and prepayment speed projections are reasonable in light of historical experience and current market expectations; and
- Ensure that charges against the book value of PMSR are recorded as the impairment tests dictate.

9. Review the fair market valuations performed on the thrift's PMSR portfolio:

- Verify that the thrift is performing the requisite quarterly fair market valuation of its PMSR portfolio; and
- If the book value of PMSR exceeds 25% of the thrift's core capital, verify that the required annual independent valuation has been obtained.

10. Review sales of servicing rights:

- If the rights that were sold had previously been recorded on the balance sheet as ESFR or PMSR, ensure that the asset is written off before any gain or loss is recognized on the income statement; and

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- If the rights relate to mortgages that have been retained by the thrift, ensure that no immediate income statement recognition has taken place.

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11. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
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Level II

12. See Section 576, Servicing, for the checklist on the valuation of PMSR and limitations for its inclusion in regulatory capital.
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13. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
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Examiner's Summary, Recommendations, and Comments

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